UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

In re:	§	
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SCOTIA DEVELOPMENT LLC,	§	Case No. 07-20027-C-11
	§	Jointly Administered
Debtor.	§	(Chapter 11)

PALCO DEBTORS' BRIEF
IN SUPPORT OF ITS JOINDER
IN THE SCOPAC OBJECTION [Docket No 377]
TO THE NOTEHOLDER COMMITTEE'S AMENDED MOTION FOR (A) DETERMINATION THAT SCOTIA PACIFIC COMPANY LLC IS A SINGLE ASSET REAL ESTATE DEBTOR, AND (B) ORDER REQUIRING THAT SCOTIA PACIFIC COMPLY WITH THE REQUIREMENTS OF BANKRUPTCY CODE § 362(d)(3)

TO THE HONORABLE RICHARD SCHMIDT, UNITED STATES BANKRUPTCY JUDGE:

Scotia Development Company LLC ("Scotia Development"), The Pacific Lumber Company ("Palco"), Britt Lumber Co., Inc. ("Britt"), Salmon Creek LLC ("Salmon Creek") and Scotia Inn Inc. ("Scotia Inn") [collectively the "Palco Debtors"] file their BRIEF n Support of its Joinder in the Objection of Scotia Pacific Company LLC ("Scopac") to the Ad Hoc Committee of Noteholder's Single Asset Real Estate Motion, as follows:

A. SCOPAC'S REVENUES ARE THE PRODUCT OF COMMERCIAL ENDEAVORS OF ITS EMPLOYEES, NOT THE PASSIVE RECEIPT OF INVESTMENT INCOME.

1. The Ad Hoc Committee acknowledges that:

(i) Scopac is operating a business on the Scopac Timber.

(ii) The majority of Scopac's revenue is generated from the sale of its logs. *See* Ad Hoc Committee Motion at ¶ 11.

(iii) Scopac employs a "limited" number of "non-ministerial" employees engaged in "forest stewardship." *See* Ad Hoc Committee Motion at ¶ 12,

Notwithstanding these issue-dispositive admissions, the Ad Hoc Committee argues that Scopac's business should be considered a "single asset real estate debtor" an argument clearly designed to further its stated goal (announced in open court during the venue motion hearings) that it desires to foreclose on the collateral and undertake the management and harvesting of timber.

2. In fact, the Ad Hoc Committee's position is based on a fundamental rejection (or ignoring) of bankruptcy jurisprudence consistently evolving since the inception of the Bankruptcy Code and the distinction it makes between single asset real estate ("SARE") debtors. The overriding common characteristic of a SARE: ***passive owned real*** estate solely for investment. Debtors, whose businesses are actively operated, are not SARE. It is beyond argument that Scopac does not passively await the receipt of income from its timber land (there would be none if Scopac were passive), and its substantial business operations, quite simply, have nothing to do with the underlying purposes of the single asset real estate provisions of the Bankruptcy Code.

1. The History of the Single Asset Real Estate Cases Demonstrate that Scopac Could Not Possibly be Classified as a Single Asset Real Estate Debtor.

3. The history of the SARE issue begins shortly after the Bankruptcy Code was enacted and includes the amended Bankruptcy Code in 1994 and 2005. Courts, bankruptcy litigants, and commentators raised serious questions about whether an entity whose sole asset was overencumbered real estate and whose only income derived from its passive use of the land should be able to "reorganize" under chapter XI of the Bankruptcy Act, or later chapter 11 of the Bankruptcy Code. Many of these cases involved ownership of raw land and others involved real estate holdings with minimal economic activity. In dealing with these cases before the Code provisions, Courts pointed to an absence of economic activity, the absence of significant

employees or "going concern value," and often, to the fact that the case really involved an effort to preserve equity interests at the expense of undersecured creditors as contrary to the absolute priority rule. *See*, *e.g.*, ***Humble Place Joint Venture v. Fory (In re Humble Place Joint Venture)***, 936 F.2d 814, 817 (5th Cir. 1991) (dismissing chapter 11 case of commercial developer whose sole asset was undeveloped real property whose business consisted of "mowing the grass and waiting for market conditions to turn" and whose reason for filing was to relieve insiders of personal guarantees).[1]

4. Almost without exception these "single asset real estate" cases involved a debtor who was passively holding real estate as an investment vehicle and whose income derived entirely from income generated by the real estate or the debtor waiting for a market upturn, not from the debtor's operations on the real estate. In ***Humble Place***, the debtor's principal acknowledged that the business had "for several years consisted of 'mowing the grass and waiting for market conditions to turn.'" ***Id.*** at 817; *see also*, ***Little Creek Dev. Co. v.***

[1] *In re Lake Ridge Assocs.*, 169 B.R. 576 (E.D. Va. 1994) (dismissing chapter 11 bankruptcy case filed by debtor whose sole asset was undeveloped real property where debtor had no equity in property and debtor proposed a liquidating plan of reorganization); *Loudoun L.P. v. Nattchase Assocs. LP (In re Nattchase Assocs. LP)*, 178 B.R. 409 (Bankr. E.D. Va. 1994) (lifting automatic stay where debtor's sole asset was undeveloped real property and prospective rents from the property would not be sufficient to service debt secured by the property); *In re D & W Realty Corp.*, 165 B.R. 127, 127-28 (Bankr. S.D.N.Y. 1994) (refusing to allow cramdown on secured lender where debtor's sole asset was an office building and secured lender was undersecured); *In re Dollar Associates*, 172 B.R. 945 (Bankr. N.D. Ca. 1994) (denying confirmation of a plan of reorganization for a debtor whose sole asset was an office building where the plan proposed to impair the secured creditor and give value back to the equity holders); *First American Bank v. Monica Road Assocs. (In re Monica Road Assocs.)*, 147 B.R. 385, 393 (Bankr. E.D. Va. 1992) (lifting automatic stay to allow secured lender to foreclose on debtor's sole asset because "debtor owns nothing but undeveloped land that is generating expenses but no income. The Debtor does not conduct any business and is not proposing in its Plan to reorganize in a manner that will generate any income to pay debt service."); *In re 499 W. Warren St. Assocs. L.P.*, 151 B.R. 307, 309-310 (Bankr. N.D.N.Y. 1992) (dismissing case filed by debtor whose sole asset was an office building, where debtor had no equity in the office building and the plan of reorganization was premised on rent being sufficient to support debt service); *In re Sar-Manco, Inc.*, 70 B.R. 132, 139 (Bankr. M.D. Fla. 1986) (lifting automatic stay where debtor's sole asset was recreational vehicle parking lot and rent from the lot would not be sufficient to service the secured debt); *but see*, *In re Clinton Fields, Inc.*, 168 B.R. 265 (Bankr. M.D. Ga. 1994) (denying relief from the automatic stay to foreclose on debtor's sole asset, undeveloped real property, where debtor had equity in the real property and debtor proposed plan evidencing a meaningful chance of a successful reorganization).

Commonwealth Mortgage Co. (In re Little Creek Dev. Co.), 779 F.2d 1068 (5th Cir. 1986) (debtor's sole asset was undeveloped real property that generated no income).[2] These cases did not turn on whether the debtor's asset base consisted solely of a parcel of real estate, but rather, whether the debtor was engaged in an active business on its real estate – a business with active operations, employees and good will to preserve, and one which could benefit from a business reorganization.[3] *See*, e.g., ***In re Majestic Motel Assocs.***, 131 B.R. 523 (Bankr. D. Me. 1991) (holding that fees collected by a motel were not "rents" because the operation of a motel was not comparable to collecting rent on real property); ***In re Metro Ltd.***, 108 B.R. 684 (Bankr. D. Mi. 1988) (holding that the limits on single asset real estate cases were not applicable to an entity that owned farmland and controlled the operations thereon). ***In re Metro Ltd***. is illustrative. The debtor in ***Metro*** owned a large parcel of farmland that was encumbered by both a consensual lien and a lien by the relevant taxing authorities. The debtor filed a chapter 11 bankruptcy as a result of a cash flow problem, and the secured lender subsequently moved to dismiss the case arguing, among other things, that the debtor was "merely a passive investor." ***Id***. at 686. The court denied the secured lender's motion holding that the debtor was not a passive investor because the debtor did not simply lease its property to outside farming companies, and instead "owns the

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[2] *In re Lake Ridge Assocs.*, 169 B.R. at 579 (debtor's sole asset was undeveloped real property and its only income was derived from the property); *In re Nattchase Assocs.*, 178 B.R. at 409 (debtor's sole asset was undeveloped real property and its only income would be rent from the property); *In re D & W Realty Corp.*, 165 B.R. at 127-28 (debtor's sole asset was an office building and its only source of income was from rent); *In re Monica Road Assocs.*, 147 B.R. at 393 (debtor's sole asset was undeveloped land which generated no income); *In re 499 W. Warren St. Assocs. L.P.*, 151 B.R. at 309-310 (debtor's sole asset was an office building and its sole source of income was rents); *In re Sar-Manco, Inc.*, 70 B.R. at 139 (debtor's sole asset was recreational vehicle parking lot and its sole income was derived from rent from the lot would not be sufficient to service the secured debt); *see also*, *In re Vienna Park Properties*, 125 B.R. 84 (S.D.N.Y 1991) (noting that case was a "single asset real estate" case where the debtor's sole asset was an apartment building).

[3] There was another alleged "problem" with single asset real estate cases. Courts frequently sustained plans that permitted equity to cram down the claim of an undersecured lender, eliminate all or most of the deficiency and retain the upside. The Supreme Court effectively put a stop to this in *Bank of America Nat. Trust & Sav. Assn. v. 203 N. LaSalle St. P'Ship*, 526 U.S. 434 (1999).

property securing the indebtedness and controls the business of operating that property." ***Id.*** at 687. In short, an active farm is not a single asset real estate case.

5. The difference between a bankruptcy court's treatment of a passive single asset real estate debtor and an active business is further explicated by the court in ***In re Mayer Pollock Steel Corp.***, 174 B.R. 414, 422-23 (Bankr. E.D. Pa. 1994). The court in ***Mayer Pollock Steel***, in the context of a dispute over plan feasibility, distinguished between "single asset real estate entities attempting to cling to ownership in an distressed market" and an operating business that can appropriately access the protections of Chapter 11. The debtors proposed a plan of reorganization over the objection of its largest secured creditor. The creditor argued, among other things, that the plan was not feasible. In making this argument, the creditor relied on a number of single asset real estate cases. The court rejected the creditor's argument holding that unlike a single asset debtor, a debtor operating a business typically has unsecured creditors in addition to its secured lenders, and there are "real jobs and production of assets in the national economy at stake if plan confirmation is denied . . . and liquidation follows." ***Id.*** at 423.

6. Accordingly, the history of Single Asset Real Estate cases prior to enactment of the Single Asset Real Estate provisions in 1994 undoubtedly demonstrate that debtors with active business operations subject to constant changes and adaptations like Scopac are not Single Asset Real Estate debtors.

2. The Enactment of the Single Asset Real Estate Provisions in 1994 Did Not Change the Fundamental Analysis – Is the Debtor a <u>Passive Investment</u> or an Active Business.

7. In 1994, Congress added two new sections to the Bankruptcy Code to deal with the SARE issue. First, Congress added the definition of "single asset real estate" to section 101 of the Code.[4]

> Section 101(51B) as enacted, defined single asset real estate as:
> [R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, ***which generates substantially all of the gross income of the debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto*** having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000. [Emphasis added.]

Congress also amended Section 362 of the Bankruptcy Code to both clarify that a single asset real estate debtor can file a plan of reorganization and that such a debtor's secured lender should not be forced to bear the economic risk of loss in a lengthy bankruptcy case.[5] This definition has two important elements relevant to this case:

(i) "***Real Property . . . which generates substantially all of the gross income of the debtor*** . . ." As noted in ***In re Club Golf Partners***, L.P., Case No. 07-40096 (Bankr. E.D. Tex., Feb. 15, 2007), the Honorable Judge Rhodes held that as to a golf course

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[4] Section 101(51B) as enacted, defined single asset real estate as:
> [R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of the debtor ***and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto*** having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000. [Emphasis added.]

11 U.S.C. § 101(51B) (repealed 2005).

[5] Section 362(d)(3),as enacted, provides:
> With respect to a stay of an act against a single asset real estate . . . by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90 day period)
> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
> (B) the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien) are in an amount equal to interest at a current fair market rate on the value of the creditors interest in the real estate.

11 U.S.C. § 362(d)(3) (repealed 2005).

> "[t]he . . . real estate does not generate the revenue; revenue is the product of the efforts of the management and workers conducted on the land, bringing in the customers and selling services and goods to them. ***Id***. at pg. 5 [*See*, Tab 1 attached].

So also, here Scotia's real estate generates itself no income. If Scotia's employees are not working, no timber harvest will occur – no revenue will occur.

(ii) "***Real Property . . . on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto***." Again Judge Rhodes ***Club Golf*** views this portion of the definition, in regards to a real estate owned and operated as a golf course that

> "in order to be a single asset real estate, the revenues received by the owner must be passive in nature; the owner must not be conducting any active business, other than merely 'operating the real property and activities incidental thereto (as) in the Fifth Circuit's memorable phrase, 'mowing the grass and waiting for the market to turn.'" ***Id***. at pg. 6.

From every possible analysis, Scopac's business activity greatly exceeds the minimum requirements of "substantial business" activity on the timberlands.

8. Thus, even though Section 101(51B) failed to elaborate on what constitutes a "substantial business" and courts hearing "single asset real estate" arguments after section 101(51B) was enacted have found little legislative history surrounding the amendments, [6] it has been noted that

> ". . . the definition of single asset real estate in the Code § 101(51B) was only slightly revised in 2005 (and) the authoritativeness of the 199402005 case law interpreting and applying the earlier version of the definition should continue." Id. at pg. 5.

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[6] *See In re Oceanside Mission Associates*, 192 B.R. 232, 234 (Bankr. S.D. Cal. 1996) (finding the legislative history to section 101(51B) "not illuminating"); *In re Philmont Development Co.*, 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995) (finding the legislative history to be "unfortunately ambiguous"). In amending the Bankruptcy Code, however, Congress did not write on a "clean slate." *See Deswnup v. Timm*, 502 U.S. 410, 419 (1992). "The drafters of sections 101(51B) and 362(d)(3) were aware of the colloquial use of the phrase 'single asset real estate.'" *In re Oceanside Mission Associates*, 192 B.R. at 236.

As discussed above, the term single asset real estate was a "well-known and . . . often used colloquialism[] which essentially referr[ed] to real estate entities attempting to cling to ownership of real property in a depressed market . . . rather than involving manufacturing, sales or services." ***In re Philmont Development Co.***, 181 B.R. at 223; *see also*, ***In re Kkemko*, Inc.**, 181 B.R. 47, 50 (Bankr. S.D. Ohio 1995) (describing history of section 101(51B)). However, because the treatment of SARE cases often dealt with the extent to which there was an active business being conducted in connection with the real estate, Court, as noted below, maintained the uniformity of case law.

3. Subsequent Case Law Interpreting the Single Asset Real Estate Provisions Continued the Same Analysis as Prior Case Law.

9. Courts considering single asset real estate issues after the amendments have not lost sight of the pre-amendment practice and have taken a practical view that "single asset real estate" is reserved for a particular factual scenario:

> That situation is where the owner of an encumbered building is attempting to avert loss of his building to his major lender who is grossly undersecured and where there is no hope that the owner can come forth with a viable confirmable Chapter 11 plan.

In re Kkemko, 181 B.R. at 51; *See, also*, ***In re Philmont Development Co.***, 181 B.R. at 223 (holding in respect of a single asset real estate debtor, there was a "common situation, i.e., typically apartment building, office building or 'strip' shopping center owned by an entity whose sole purpose was to operate that real estate with monies generated by the real estate"); *see also*, ***In re 234-6 West 22nd Street Corp.***, 214 B.R. 751, 759-60 (Bankr. S.D.N.Y. 1997) ("It is important to draw the distinction here. On the one hand, there is nothing inimical to the purposes of the Bankruptcy Code in the shrewd identification of the net present value and hidden potential

for successful rehabilitation of a struggling business. On the other hand, a debtor shows bad faith when it uses bankruptcy protection for risk-free speculation in the single asset."). These holdings continued the analysis the uniformity Courts applied -- that Section 101(51B) applies only to the limited subset of debtors who are only passive real estate investment vehicles, and does not apply where a debtor's legitimate business activities are performed on real property. *See* ***Centofonte v. CBJ Development, Inc. (In re CBJ Development, Inc.)***, 202 B.R. 467, 472 (9th Cir. BAP 1996) (finding that hotel operations constitute a business and thus debtor-hotel operator was not a single asset real estate entity).[7] Indeed Congress, in the otherwise sparse legislative history of Section 101(51B), stated explicitly that the "***definition is limited to investment property of the debtor***." S. Rep. No. 168, 103rd Cong., 1st Sess. (October 28, 1993) [Emphasis added.]

4. The 2005 Amendment Does Not Change the Fundamental Analysis – Is the Debtor a Passive Investment Vehicle or an Active Business?

10. In 2005, Congress again amended Section 101(51B) of the Bankruptcy Code to remove the $4 million cap on single asset real estate entities. The Ad Hoc Committee's unsupportable argument that Scopac is precisely the type of business that this change was meant to apply [*See* Ad Hoc Committee Motion at ¶ 31] ignores not only the amendment but the holdings of the limited case law after the 2005 amendment that preserves the distinction between an active business taking place on real estate and a passive investment. In ***In re Club Golf***

[7] *In re Whispering Pines Estate, Inc.*, 341 B.R. 134, 136 (Bankr. D.N.H. 2006) (hotel operations constitute a business on the property); *In re Larry Godwin Golf, Inc.*, 219 B.R. 391, 393 (Bankr. M.D.N.C. 1997) (holding that the definition of single asset real estate "includes the operation or holding of a piece of real estate for income rather than the operation of a business on the real estate."); *In re Prairie Hills Golf & Ski Club, Inc.*, 255 B.R. 228, 230 (Bankr. D. Neb. 2000) (denying request for relief from the stay because debtor "does not simply hold a passive investment" and is "actively conducting various enterprises on the property . . . .").

Partners, L.P., Case No. 07-40096 (Bankr. E.D. Tex., Feb. 15, 2007), the Honorable Judge Rhodes held that case law from 1994-2005:

> "interpreted § 101(51B) such that a debtor that not only owns real estate but also operates a variety of income revenue producing activities on it, employs third party employees, without whom nothing would happen on the property, enjoys revenue from a variety of active commercial activities on the property that are dependent on the entrepreneurial efforts and hard work of its principals and its other employees, and does not simply lease its property to tenants as the owner of true single asset real estate such as an apartment house does, does not fall within the scope of the definition of 'single asset real estate' in Code § 101(51B) and is not subject to § 362(d)(3)." [*See*, Tab 1 attached hereto].

It is clear from ***Club Golf Partners*** that nothing in the recent amendments changed the definition or the scope of prior case law defining a SARE, although other substantive changes were made and expressed in the amendments.

5. A Summary of Scopac's Activities on its Property Clearly Demonstrates it is an Active Business Operation.

11. Scopac is clearly engaged in an active economic enterprise on its property and these activities (outlined in detail in both Scopac's Response and Palco's Joinder in that Response) are extensive and require hands-on supervision by teams of experts. The overwhelming majority of Scopac's employees have four-year college degrees in one of the many disciplines necessary to ensure that the Scopac Timber is managed profitably, reliably, and in compliance with the dizzying array of federal, state, and local rules and regulations. All of which must be done if Scopac is to be able to sell logs profitably. It is obvious that Scopac is far from a passive investment vehicle, and bears no resemblance to a debtor who seeks to preserve non-existing equity at the expense of creditors. Scopac's revenues are not akin to rent generated by the property.[8]

[8] Scopac's revenue is the product of its extensive Silvicultural Operations, which take place on its property. To borrow from the Court in *Mayer Pollock Steel*, harvesting trees for processing into lumber "may not be the

12. In short, Scopac is a complex and active commercial enterprise.[9] Scopac has a number of employees engaged in activities necessary to the production of revenue. Scopac's Chapter 11 case, if successful, will preserve these jobs as well as the source of a commodity valuable to the marketplace. Based simply on the underlying purposes of the single asset real estate provisions of the Bankruptcy Code, the SARE Motion is unfounded and must be denied. Indeed, the Ad Hoc Committee has cited no cases in which activities comparable to those of Scopac were not held to be a substantial business.

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backbone of the economy or take its place among the most socially significant accomplishments of man, but preservation of entities like [Scopac] is, to a large extent, what Chapter 11 of the Bankruptcy Code is all about." 174 B.R. at 423.

[9] The Ad Hoc Committee has repeatedly asserted, most recently in the Initial Response to the Motions to Transfer Venue, that Scopac's business somehow violates Scopac's covenants in Indenture. Specifically, the Ad Hoc Committee argues that Section 4.14 of the Indenture restricts Scopac's business activity to "the operation, management, sale or maintenance of the Company Owned Timberlands, the Company Timber Rights and the Company Timber" or actions "reasonably incidental" thereto. Indenture at § 4.14. While Scopac has refrained from addressing irrelevant arguments, this one bears some mention. While somewhat tautological, business means, among other things, " a usually commercial or mercantile activity engaged in as a means of livelihood; . . . a commercial or sometimes an industrial enterprise; [or] dealings or transactions especially of an economic nature." Merriam Webster's Dictionary (rev. ed. 2005). As set forth above, Scopac's "substantial business activity" is directly necessary to Scopac's sale of trees, and therefore falls within the ordinary definition of "business." If, as the Ad Hoc Committee suggests is the proper status quo, Scopac were unable to carry out its activities, there would be no one to process the necessary applications to implement the harvest of Scopac's trees, and, quite frankly, fewer trees to harvest. Moreover, the very suggestion that the activities described above are not at the least "reasonably incidental" to the activities of a sales company operating in a heavily regulated marketplace has no merit and, in fact, borders on the frivolous. Further, when considering the overlay of the complex regulatory scheme regarding the sale of logs from the Scopac Timber, the borders of frivolity may have been crossed.

Moreover, the Ad Hoc Committee's first quotation above, "the operation, ….Company Timber" conveniently leaves off a very important qualifier that follows, namely "as provided by the Operative Documents." The "Operative Documents" consist of a complex set of agreements and instruments, including the Indenture governing the Timber Notes (which is well over 100 pages long, including 30 pages of definitions, and as might be imagined by its mere length, has any number of complicated provisions), a 70-plus page Deed of Trust, and the purchase agreement and services agreement between Palco and Scopac. The Ad Hoc Committee also conveniently omits additional business activities allowed by Section 4.14 of the Indenture: "(ii) the execution, delivery and performance of the Operative Documents, the Line of Credit Agreement, and the New Additional Services Agreement … (v) acquiring Additional Timber Property…" Subsequent to the closing of the Timber Notes offering, Scopac acquired thousands of acres of Additional Timber Property in many different transactions. Again, hardly the mark of a passive operation.

B. SCOPAC DOES NOT SATISFY THE STATUTORY CRITERIA FOR A SINGLE ASSET REAL ESTATE DEBTOR.

13. Scopac does not satisfy any of the statutory elements of a single asset real estate entity and, therefore, the SARE Motion must be denied. Section 101(51B) of the Bankruptcy Code, as amended, defines "single asset real estate" as:

> [R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of the debtor who is not a family farmer ***and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental***. [Emphasis added.]

11 U.S.C. § 101(51B). Under the Bankruptcy Code, each of the following three criteria must be met in order for Scopac to constitute a single asset real estate debtor: (i) the debtor owns real property constituting a single property or project (other than residential property with fewer than 4 units); (ii) the real property generates substantially all of the income of the debtor; and (iii) the debtor must not be involved in any substantial business other than the operation of its real property and the activities incidental thereto.

1. Scopac Does Not Own Property Constituting a Single Property or Project Because Timber Rights are Not Appurtenant to the Land and are Not Real Estate Under Either the Bankruptcy Code or California Statute.

14. The Ad Hoc Committee argues that Scopac's various property holdings constitute a "single property or project" for the purposes of the single asset real estate provisions of the Bankruptcy Code. Scopac holds both approximately 200,000 acres of virtually, but not entirely contiguous land as well as the exclusive right to harvest trees on approximately 12,000 acres of property owned by Palco and another Palco subsidiary. The Ad Hoc Committee argues that Scopac's right to harvest trees on property owned by third parties should constitute a "single project" because, under California tax law, Scotia's right to harvest property is appurtenant to land and thus constitutes "real property." *See* SARE Motion at ¶ 17. However, it is Bankruptcy

law, not state law, that determines what constitutes "real estate" for the purposes of Section 101(51B). *See* ***In re Kkemko, Inc.***, 181 B.R. at 51. In ***Kkemko***, a creditor argued that a marina was a single asset real estate entity. Its argument was based, in part, on the fact that under state real estate law, 240 contiguous mooring platforms operated by the debtor were attached to land and thus were considered "real estate." The bankruptcy court rejected this position outright and held that the mere fact that the docks were appurtenant to land, does not render them real estate for the purposes of the single asset real estate provisions of the Bankruptcy Code. The Court held that

> "[o]nly by applying concepts of real estate law, fixture law can the holdings of debtor be regarded as a part of debtor's real estate, and it is clear to us that it is bankruptcy law which is determinative here, not a consideration of what is real estate for the purposes of state real estate law." ***Id.***

This analysis is consistent with the purpose of bankruptcy law to deal with situations involving economic activity, and this purpose has nothing to do with abstract notions of what may or may not be real estate for state law purposes, let alone for tax purposes.

15. Scopac clearly does not merely hold a single property. Scopac owns approximately 200,000 acres of virtually, but not entirely, contiguous real property, and the right to harvest on land owned by third parties. Based on the court's reasoning in ***Kkemko***, the right to harvest is not real estate merely because it is appurtenant to land. Moreover, pursuant to the California U.C.C., cutting timber is considered a sale of goods. Section 2017 of the California U.C.C. provides:

> A contract for the sale apart from the land of growing crops or other things attached to realty and capable of severance without material harm thereto . . . or of timber to be cut *is a contract for the sale of goods* within this division whether the subject matter is to be severed by the buyer or by the seller even though it forms part of the realty at the time of contracting, and the parties can by identification effect a present sale before severance."

Cal. Comm. Code § 2017 (emphasis added). Accordingly, pursuant to both California statue and applicable bankruptcy case law, then, Scopac's holdings do not constitute a single project.

16. The Ad Hoc Committee chooses to completely ignores these court mandated principles and instead focuses on numerous cases involving non-contiguous parcels of real property ***that are held as passive investment vehicles*** held to a "single project" for the purposes of a Section 101(51B).[10] The cases cited by the Ad Hoc Committee to support this misdirection are so easily distinguishable -- none of them deals with an operating business, much less a complex silvicultural enterprise such as Scopac's. Furthermore, all of the Ad Hoc Committee's cases deal with passive investment vehicles that would otherwise fall within the scope of Section 101(51B). Again, the Ad Hoc Committee does not cite one case remotely resembling Scopac's actual facts. There are such cases, but those authorities do not support the Ad Hoc Committee's position so they are simply ignored. Those cases are set out in this Brief.

2. The Active Entrepreneurial Labor of Scopac's Employees Generate Scopac's Revenue, not Merely Passive Ownership of the Timberlands.

17. The Ad Hoc Committee admits that Scopac's income is generated from its sale of timber growing on the Scopac Timber land – but suggests that Scopac does nothing substantial except to watch its timber grow. Scopac's revenue, however, is not the result of a passive investment (that is, in fact, the Noteholders posture) but the result of the fruit of Scopac's employees' labor. If Scopac does not furnish the services necessary to generate the revenue, there is no revenue. Indeed, the Ad Hoc Committee's argument would mean the every operating

[10] *See, e.g.*, *In re Cambridge Woodhouse Apartments, LLC*, 292 B.R. 832, 834 (Bankr. N.D. Ohio 2003)(company whose only asset was apartment units held to be single asset real estate debtor); *In re Philmont Dev. Co.*, 181 B.R. at 225 (debtor whose sole asset were semi-detached houses held to be a single asset real estate debtor); *In re 83-84 116th Owners Corp.*, 214 B.R. 530 (Bankr. E.D.N.Y. 1997)(co-operative housing complex held to be single asset real estate); *The Whitfield Co. v. Tad's Real Estate Co., Inc. (In re Tad's Real Estate Co., Inc.)*, 1998 WL 34066143 at *1 (Bankr. S.D. Ga. Mar. 23, 1998)(semi-developed land held to be single asset real estate).

farm was a single asset real estate case because the revenues are generated by crops grown on the land. Chapter 12 is a clear rejection of this view.

18, In this context, courts have repeatedly recognized the distinction between revenue generated from owning property and revenue earned from employees' labor occurring on property. The former category refers primarily to rental or other investment income. *See* ***In re Philmont Dev. Co.***, 181 B.R. at 223 (noting that the debtors' income consisted of the rentals of the debtor's real property). Rental income is not generated by the debtor's activities, and with a minimum amount of effort a debtor can sit back and collect rents. Where a debtor is actively using property in its operations, however, courts regularly find that any revenue generated is attributable to the operation and not the property. *See* ***Prairie Hills Golf & Ski Club, Inc.***, 255 B.R. at 229 (attributing the debtor's income to various enterprises occurring on the debtor's property); ***Larry Goodwin Golf, Inc.***, 219 B.R. at 392. ***In re Majestic Motel Associates***, 131 B.R. at 523 is instructive. The court in ***Majestic Motel*** was asked to consider whether revenues generated by guests staying in the debtor's motel were similar to "rental income." The court held that motel revenues are not rents

> "derived from the real property itself, but are generated in large part by the labor and incidental services which the hotel business necessarily furnishes to its guests. A hotel guest does not obtain an interest in the real property but is a mere licensee with a personal right to use the premises." 131 B.R. at 526.

Similarly, timber sale revenues are not passive rent collection as the Committee would have this Court analogize. Without Scopac's multi-million dollar-per-year "services" to manage, maintain, and comply with all that is required in order to sell a single tree, no timber harvesting enterprise revenues could exist. Scopac's revenues are the product of its expansive commercial silvicultural operations by its employees *which occur on its property*. Scopac's revenues are not

comparable to rent revenues -- Scopac engages in a myriad of complex procedures and operations, including preparing, designing and implementing THPs for every log to be harvested, as part of the services required to allow timber harvesting. If Scopac's employees were to stop rendering these active services, Scopac would cease generating revenue. It is indisputable that if the Scopac services stop, the revenue stops and, thus, Scopac clearly does not meet this element of the definition of single asset real estate.

3. Scopac Operates a Substantial Commercial Business on the Property.

19. The final element of the "single asset real estate" analysis examines whether the debtor is engaged in "substantial business" other than operating the real property; this is the heart of the single asset real estate analysis. Courts typically analyze "whether the real estate is used in the operation of a business or whether it is simply held for income." ***Prairie Hills Golf & Ski Club, Inc.***, 255 B.R. at 229, *citing* ***In re Kkemko, Inc.***, 181 B.R. at 51. In conducting this analysis, courts have consistently held that a debtor who actively operates a business on its property, even when the operation of such business centers around the debtor's property, does not constitute a "single asset real estate" debtor.[11]

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[11] *See*, *e.g.*, *In re CBJ Development, Inc.*, 202 B.R. at 472 (finding that hotel operations were not the mere "operation of a property" because it required (i) a substantial number of employees; (ii) actively maintaining each of the rooms, (iii) cleaning bed sheets and towels; and (iii) providing basic amenities to guests, specifically phone service; moreover, the hotel operated a gift shop and restaurant); *In re Whispering Pines Estate, Inc.*, 341 B.R. at 136 (hotel operations, even without restaurant and gift shop, constitute more than "the business of operating the real property"); *Prairie Hills Golf & Ski Club, Inc.*, 255 B.R. at 229 (operation of golf and ski facilities connected to residential land developments is not merely operating property); *Larry Goodwin Golf, Inc.*, 219 B.R. at 393 (operation of a golf course and pool with concession stand is not merely operating property).

In contrast, passive activities that fall within the meaning of section 101(51B) of the Bankruptcy Code are the mere receipt of rent, and activities incidental thereto, including maintenance of the property (i.e. mowing the lawn) or marketing of the property. As the court in *Humble Place* described, "mowing the grass and waiting for market conditions to turn" is the type of passive activity indicative of a single asset real estate entity.

The Ad Hoc Committee, undaunted by the applicable case law, which compels that their Motion be denied, argues that Scopac's operations on the Scopac Timber are not "substantial" as the term is used in Section 101(51B). Courts generally find that significant day-to-day activity on the property constitutes substantial business. *See In re CBJ Development, Inc.*, 202 B.R. at 472 (noting that a hotel is not single asset real estate

20. The Ad Hoc Committee argues Scopac's "only" activities include protection of the forest from forest fires, erosion, insects and other damage, overseeing reforestation activities, and monitoring and implementing environmental and regulatory compliance. Even if that was all Scopac did, (at the cost of millions of dollars per year) it could never be considered a passive investment vehicle. Assuming, for a moment, that these are the only activities that Scopac is engaged in, they clearly are sufficient to constitute "significant business" under the case law interpreting Section 101(51B).

21. Scopac's business is not designed to simply profit from a sale of the land at an increased value. Scopac engages in significant day-to-day operations that are necessary to maximize the value of the Scopac Timber and to ensure future development of Scopac's assets. Each activity is designed not to maintain the status quo of the property but to increase the value of the Scopac Timber. The facts of Scopac's day-to-day operations are clearly similar to operations taking place on golf and ski resorts, which courts consistently find are not single asset real estate entities. *See* ***Prairie Hills Golf & Ski Club, Inc.***, 255 B.R. at 229; ***Larry Goodwin Golf, Inc.***, 219 B.R. at 392; ***In re CGE Shattuck***, 1999 WL 33457789 at *8 ("As the Debtor's business activities evidence, the operation of a golf course involves significant income-producing activities that exist independently of the operation of the real estate."); ***In re Club Golf Partners***, L.P., Case No. 07-40096 (Bankr. E.D. Tex., Feb. 15, 2007).

22. The Ad Hoc Committee argues that Scopac's "forest stewardship activities" do not rise to the level of "substantial business." This, of course, ignores the Scopac budgets and

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because management of a hotel "requires substantially more day to day activity than does operation of an apartment complex" which only requires minimal maintenance that is primarily limited to common areas). Moreover where a debtor "constructs and maintains roads to the golf ski and residential areas, mows and removes snow from the golf course and residential area, continues to develop the golf and ski areas," operates concessions and operates farmland, the debtor is engaged in substantial business. *Prairie Hills Golf & Ski Club, Inc.*, 255 B.R. at 230.

MORs supplied to the Ad Hoc Committee, which means the Ad Hoc Committee again elects to wholly ignores the $3 million per year in science, $6 million in road maintenance (HCP compliance) and another approximately $4 million in G&A specifically dedicated to the "substantial business" absolutely necessary for Scopac to earn any revenue.

23. Even the Noteholders' Trustee BoNY argues that "Scopac looks more like a single asset real estate debtor than it doesn't." Both arguments simply reflect the blind leading the blind (that is, blind by electing to not see the facts). Scopac's Silvicultural Operations are an interdisciplinary mix of science, forestry, and business management. Scopac's operations incorporate botany, wildlife biology, fisheries, hydrology, geology, geomorphology, forestry, engineering, and business management. Scopac's scientists and foresters use their interdisciplinary skills to address federal, state and local and laws and regulations, and contractual obligations, relating to erosion control, road construction, water quality, threatened and endangered plants, threatened and endangered animals, ecosystem biodiversity, site preparation, tree planting, and vegetation management while also developing long term business plans, cost reductions, and revenue maximization. This is the very definition of an active business.

24. Simply put - the Ad Hoc Committee has cited no case holding that where the debtor has operations, employees and a business similar to Scopac, or where the debtor's activities remotely approach the scope and extent of those Scopac has described extensively above and in Palco Debtors' Joinder, the enterprise is a SARE debtor. Why? No such authority exists.

C. IN ORDER TO GET AN ABSURD RESULT, THE AD HOC COMMITTEE'S ARGUMENT IGNORES THE "ECONOMIC REALITIES" OF THE INTER-COMPANY RELATIONSHIP BETWEEN PALCO AND SCOPAC.

25. The Ad Hoc Committee intuits that Scopac will bring up the complex business relationships between Scopac and Palco in order to argue that Section 362(d)(3) should not apply in these cases. They are partly correct. Section 363(d)(3) does not apply because Scopac is not a single asset real estate debtor; the complex inter-company relationships between Scopac and Palco are simply further evidence that Scopac is not a single asset real estate debtor. While Scopac is a separate entity for corporate governance purposes, it remains integrated into Palco's operations, and but for the myriad of contractual obligations and related service performed by Scopac, Palco could not harvest Scopac timber. The Ad Hoc Committee's argument that the Court could simply carve Scopac out of this complex corporate structure defies logic. This argument misconstrues the economic reality of these cases; it is not economically feasible to separate the business and corporate relationship of Scopac from Palco. This postulation is as ridiculous as the Noteholders' announcement at the prior venue hearing that their goal was to take over operations of the timber harvesting. ***Commerce Bank & Trust Co v. Perry Hollow Golf Club, Inc. (In re Perry Hollow Golf Club, Inc.)***, 2000 WL 33679447 (Bankr.D.N.H. April 6, 2000), dealt with a similar situation recognizing that the economic realities of the case should govern. In ***Perry Hollow Golf Club***, the debtor was a special purpose entity created to hold title to a golf course. The golf course was pledged as collateral for a loan. The debtor's co-debtor parent operated the golf course and made payments to the debtor pursuant to a "lease" agreement. The secured lender argued that because the debtor-land owner's sole asset was real estate and its sole source of income was rent derived from the lease, it was a single asset real estate debtor. The court parsed the economic substance of the transactions and held, instead, that

the golf course constituted a single entity. ***Id.*** at * 1-2. Compare this to the intricately combined expertise of Scopac (in particular, it personnel and science) and Palco developed over almost 20 years of joint efforts to accomplish the timber harvest, milling, and sale and the resulting synergies that cannot be duplicated short of years of efforts – much less overnight as suggested by the Ad Hoc Committee.

26. A similar analysis was proposed by the National Bankruptcy Review Commission. The review commission explained that their proposed definition, which was very similar to the current definition of single asset real estate, was

> designed to include real estate investors, ***and to exclude debtors who use real estate in an active business***, such as a wholly owned subsidiary that holds a building used as a factory by the parent . . . whether or not the parent . . . is also a debtor in a bankruptcy case. ***Whether the debtor uses real property in an active business should be viewed in terms of economic substance rather than the form of ownership***. Thus, where a debtor conducting an active business holds title to the real property used in that business entity, the entity holding the real property should not be considered an SARE debtor. [Emphasis Added.]

National Bankruptcy Review Commission, *Bankruptcy the Next 20 Years*, 688 (October 20, 1997). This argument makes analytical sense preventing absurd and inequitable results and the counter-intuitive arguments of the Ad Hoc Committee. If, for example, a large airline-debtor held title to one of its hangars in a separately controlled subsidiary, no court would entertain the argument that the debtor holding title to the hangar was a single asset real estate entity and should be separated from the company's operations. Similarly, in the case of a large winery debtor that holds its vineyards in a separate subsidiary from the wine making operations, no court would suffer the argument that employees at the vineyard holding entity are "just watching the grapes grow," and that the vineyard is a single asset real estate debtor. There are numerous

examples that demonstrate the absurd and inequitable results of the Ad Hoc Committee's arguments.

27. There is clearly a long history of substantial financial nexus between Scopac and Palco. As the Ad Hoc Committee mentions in its brief, Palco transferred title of the Scopac Timber to Scopac. The vast majority of Scopac's revenue comes from the sale of its timber to Palco, its parent. There are numerous agreements and numerous cross-performance obligations required of each just to harvest a single tree. This Court should also not disregard the economic reality of these cases and to do so could destroy not only the synergies and efficiencies of incredibly complex operations, but the reorganization itself. This case is very similar to the facts proposed by the Bankruptcy Review Commission and the facts addressed by the court in ***Perry Hollow Golf Club***. Palco would not constitute a single asset real estate debtor and no valid bankruptcy purpose is served by deciding this issue based solely on these companies' chosen form of ownership for the real property.

D. THE COURT SHOULD NOT ORDER COMPLIANCE WITH SECTION 363(D)(3) AT THIS TIME

28. Finally, the Ad Hoc Committee spends a disproportionate amount of time arguing that because Scopac is single asset real estate debtor, which is clearly not the case, Section 363(d)(3) should apply. This argument is somewhat awkward because a single asset real estate debtor's compliance with section 362(d)(3) is mandatory. It appears that the Ad Hoc Committee is attempting to argue that the court should not use its discretion to extend the deadlines imposed by Section 363(d)(3). Their argument, in sum, is that certain single asset cases are filed in bad faith, and therefore, Scopac should be denied at this time its statutory right to request an

extension of time under Section 362(d)(3).[12] Such an argument is at best, premature and actually makes no sense. Scopac has not yet made any request to extend the deadline, mostly because the deadline is not applicable. The Ad Hoc Committee cannot, at this time, pigeon-hole Scopac into litigating over the timing provisions of Section 363(d)(3) before this Court has had opportunity to determine whether Section 362(d)(3) is even applicable, and before Scopac could even request such relief.

29. For the reasons set forth above, the SARE Motion must be denied and the Court should find that Scopac is not a single asset real estate entity under section 101(51B) of the Bankruptcy Code.

Certificate of Service

30. In compliance with Bankruptcy Local Rule 9013(f), Debtors will file as a separate document a Certificate of Service containing the names and addresses of the parties served, the manner of service, the name and address of the server, and the date of service.

WHEREFORE, Palco Debtors' request this Court consider the arguments and authorities submitted, and enter of an order (i) denying the Motion; (ii) determining that Scopac is not a "single asset real estate" debtor under Section 101(51B) of the Bankruptcy Code; and (iii) granting Scopac such other and further relief as the Court deems just and proper.

Respectfully submitted this 29th day of March 2007.

[12] The Ad Hoc Committee also hints that they may bring an action to dismiss this case as a bad faith filing. Palco does not, at this time, feel the need to address this clearly frivolous argument but reserve its response for the Ad Hoc Committee's motion, in the event it is filed.

Respectfully submitted,

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